

Decision 06-04-037 April 13, 2006

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking on the  
Commission's Own Motion to Evaluate Existing  
Practices and Policies for Processing Offset Rate  
Increases and Balancing Accounts in the Water  
Industry to Decide Whether New Processes are  
Needed.

Rulemaking 01-12-009  
(Filed December 11, 2001)

**OPINION GRANTING PETITION FOR MODIFICATION  
OF DECISION (D.) 03-06-072**

**I. Summary**

This decision eliminates, the earnings test adopted in D.03-06-072 which currently applies to balancing account recovery for Class A water companies' balancing accounts existing on or after November 29, 2001.

**II. The Petition**

**A. Procedural Background**

On April 4, 2005, California Water Association (CWA) filed a petition for modification of D.03-06-072.<sup>1</sup> This decision revised the procedures that Class A water utilities must follow in order to recover balances from balancing accounts existing on or after November 29, 2001. CWA requests that the

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<sup>1</sup> CWA's petition requests that the Commission modify D.03-06-072, as that decision was previously modified by D.04-03-041, D.04-03-049 and D.04-10-002. All references to D.03-06-072 are to the decision as modified.

Commission address implementation problems with D.03-06-072, or alternatively, that the Commission revisit and overturn the policy implemented by that decision.

On May 4, 2005, the Office of Ratepayer Advocates (ORA)<sup>2</sup> filed a response to the petition. ORA opposes the petition, mainly on the grounds that CWA's petition is an attempt to relitigate and overturn the Commission's recently issued decision. On May 16, 2005, CWA and Park Water Company (Park) each filed a reply to ORA's comments.

### **B. The Petition's Requested Relief**

CWA's petition for modification points out implementation problems with D.03-06-072 and proposes to address those problems by eliminating the earnings test that decision applies in the context of annual balancing account reviews. Alternatively, CWA proposes several changes to address aspects of those implementation problems.

CWA's preferred approach is for the Commission to eliminate the earnings test adopted in D.03-06-072. CWA states that relying on over earning to deny a rate increase that would amortize a balancing account undercollection, while continuing to mandate rate reduction to amortize an overcollected balancing account regardless of a utility's under earning, is unfair. CWA believes the balancing account should not be adjusted for earnings but only for an exclusion of imprudently incurred expenses.

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<sup>2</sup> As a result of recent Legislation, ORA's name was recently changed to the Division of Ratepayer Advocates. We will use ORA in this decision because that was ORA's name at the time it briefed the issue.

CWA also states that the earnings test is inconsistent with the recently adopted rate case plan decision, D.04-06-018, which requires that the general revenue requirement and rates for each district of each Class A water company be reviewed on a three-year cycle. CWA argues that the new rate case plan provides an additional safeguard to prevent over earning by subjecting rate increases for the second and third year of a rate case cycle to an earnings test. Thus, according to CWA, the problem that the earnings test adopted in D.03-06-072 was designed to address, has been largely addressed through other means.

If the Commission does not eliminate the earnings test altogether, CWA also briefly sets forth what it terms to be other innovative solutions for dealing with cost offsets. One recommendation is full cost balancing accounts, and another is to abandon the use of balancing accounts altogether in favor of allowing timely cost offset rate adjustments subject to refund. CWA briefly discussed but did not fully set forth the specifics of these solutions.

CWA also set forth the following changes which the Commission should make to D.03-06-072 in order to eliminate what CWA believes are implementation problems, if the Commission does not eliminate the earnings test in its entirety. These proposals include:

- Eliminate the exclusion of extraordinary expenses and revenues from the balancing accounts.
- Net expenses recorded in the balancing account against revenue recorded in the account, before adjusting for over earning outside the account.
- Adjust sales and revenue figures to reflect normalized weather data.

- Adjust franchise fees and uncollectibles due to rate changes associated with offsettable expenses.
- Allow the ongoing maintenance of a single balancing account for each eligible category of expense (i.e., purchased power, purchased water, pump tax), rather than requiring that each account be closed at the end of each calendar year.
- Allow the staggering of the utilities' filings (this can occur, according to CWA, if the Commission allows ongoing accounts as set forth above).
- Allow, in a year the utility does not earn its authorized rate of return, the utility to recover offsettable expenses incurred but disallowed in past years when the utility over earned.

### **C. Responses and Replies to the Petition**

ORA opposes CWA's petition, arguing that it is an attempt to relitigate and overturn the Commission's sound decision in D.03-06-072. ORA argues that the implementation difficulties are largely the result of the utilities' poorly prepared compliance filings. ORA also states that D.03-06-072 provides proper treatment for extraordinary revenues and expenses. Because extraordinary expenses, according to ORA, are fairly uncommon in the water industry, the presence of these types of revenues should not distort the company's ability to recover amounts due to them in memorandum accounts.

ORA also argues that the presence of the three-year rate case cycle does not eliminate the need for D.03-06-072, because adjustments for excess utility earnings in the second or third year of a rate case cycle is not new, but has been part of the Commission's procedures for years. According to ORA, the rate case plan is designed to account for fluctuations in weather by using a weather

normalized process to forecast sales in determining authorized rates. Excess earnings in a given year are not refunded in the year they are earned, but will result in a downward adjustment in the utility's rate increase for year two by the amount of the utility's excess earnings. This is a weather-normalized procedure, since the initial estimates are based on the expectation of average weather conditions. By contrast, according to ORA, the earnings test adopted by D.03-06-072 is based on actual expenditures for purchased power, pump taxes, and water acquisition expenses. ORA believes the two tests are different, and that sales normalized adjustments should be tied to sales normalized revenue forecasts, whereas non-sales normalized adjustments should be tied to actual utility earnings.

CWA and Park replied to ORA's response. CWA states that its members have not deliberately submitted advice letter filings out of compliance with D.03-06-072.<sup>3</sup> Rather, according to CWA, problems have occurred due to the complexities in the adopted procedures. CWA also elaborates on the arguments made in its petition.

### **III. Discussion**

The balancing accounts at issue in D.03-06-072 allow the utilities to track and recover unanticipated expenses within the rate case cycle to prevent financial injury, and to serve as insurance to utilities that certain uncontrollable expenses will not affect the utilities' ability to achieve authorized earnings.

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<sup>3</sup> Park filed a reply stating that the fact that it is not a member of CWA does not mean that Park opposes CWA's petition. Park cautions that its silence on an issue when no filing is required should not be inferred as a position on an issue. Park also explains the difficulties it has had in filing its advice letters required by D.03-06-072.

These balancing accounts do not address rate design but rather, they address expenses. (See D.04-05-037.)

We adopted an earnings test to apply to balancing account recovery for accounts existing on or after November 29, 2001 to ensure that offset balancing account recovery only occurs when the utility fails to earn up to its authorized rate of return due to significant unforeseen expenses beyond its control that are the subject of the balancing account. (See D.04-03-041 at page 3.)

We also implemented the earnings test to address a related problem with the balancing account procedures. This problem occurred when a utility failed to file a general rate case application every three years, yet continued to seek balancing account treatment beyond the rate case cycle, thus depriving us of scrutiny over the assumptions used to determine rates. Use of out-of-date forecasts could lead to an unreliable measure of a utility's earnings and could provide a utility with undeserved income. (See D.04-03-041 at page 4.)

After the Commission issued D.03-06-072 adopting the earnings test, as well as D.04-03-041 denying rehearing on the decision, the Commission issued D.04-06-018 adopting a revised rate case plan for Class A water utilities. This decision ensures, with limited exception, that applications for a general rate case for Class A water utilities are placed on a three year cycle as required by Pub. Util. Code § 455.2.<sup>4</sup> Because Class A water utilities are now subject to a

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<sup>4</sup> Section 455.2(d) provides that the requirements of a three-year rate case cycle can be waived at any time by mutual consent of the Commission and the water company. D.04-06-018 provides that in situations where the Commission and the utility believe that a general rate case filing is not needed according to the rate case plan, that such an agreement should be presented to the Commission in an advice letter. Thus, the Commission would be part of the decision postponing any water general rate case.

three-year rate case cycle, the assumptions used in setting the rates will be much more current.

The Commission adopted the earnings test in D.03-06-072, at least in part, because the rate case cycles for some of the Class A water utilities had extended well beyond three years, thus resulting in the use of out-of date forecasts leading to unintended results. We have more confidence in our forecasts and assumptions under a three-year rate case plan, where the Commission scrutinizes the forecasts and assumptions used in regular intervals.

Moreover, the implementation of the earnings tests undermines Public Utilities Code §456<sup>5</sup> which would allow a water company to retain profit that it achieved through efficient operation between rate cases.

We therefore eliminate the mandate of D.03-06-072 that Class A water utilities file an advice letter by March 31 of each year, for each of their ratemaking districts, to provide a review of the status of each balancing account, to adjust rates to amortize the balance in each account, and to terminate such accounts. Instead, the Class A water utilities will be permitted to maintain such accounts as continuing balancing accounts, subject to review and amortization and rate adjustments if the positive or negative balance in any such account exceeds two percent (2%) of annual revenues for the subject company or district and subject to reasonableness review. The earnings test presently applicable to

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<sup>5</sup> “Nothing in this part shall be construed to prohibit any public utility from profiting, to the extent permitted by the commission, from any economies, efficiencies, or improvements which it may make, and from distributing by way of dividends, or otherwise, disposing of, such profits. The commission may make or permit such arrangement with any public utility as it deems wise for the purpose of encouraging economies, efficiencies, or improvements and securing the public utility making them such portion of the profits thereof as the commission determines. (Pub.Util.Code, §456.)

such rate adjustments in the context of the mandatory annual filings will be eliminated along with that mandate, and no earnings test will limit the utilities' right to amortize over-or under-collections in their balancing accounts, subject to the two-percent rule and reasonableness review, as noted above.

#### **IV. Comments on Draft Decision**

The alternate draft decision of Commissioner Bohn was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed on April 3, 2006, and reply comments were filed on April 10, 2006. No changes are made as a result.

#### **V. Assignment of Proceeding**

Geoffrey F. Brown is the Assigned Commissioner and Janet A. Econome is the assigned ALJ in this proceeding.

#### **Findings of Fact**

1. On April 4, 2005, CWA filed a petition for modification of D.03-06-072.
2. In D.03-06-072, we adopted an earnings test to apply to balancing account recovery for accounts existing on or after November 29, 2001 to ensure that offset balancing account recovery only occurs when the utility fails to earn up to its authorized rate of return due to significant unforeseen expenses beyond its control that are the subject of the balancing account.
3. We also implemented the earnings test to address a related problem with the balancing account procedures which occurred when a utility failed to file a general rate case application every three years, yet continued to seek balancing account treatment beyond the rate case cycle. The problem occurred because use of out-of-date forecasts could lead to an unreliable measure of a utility's earnings and could provide a utility with undeserved income.



4. After the Commission issued D.03-06-072 adopting the earnings test, as well as D.04-03-041 denying rehearing on the decision, the Commission issued D.04-06-018 adopting a revised rate case plan for Class A water utilities. This decision ensures, with limited exception, that applications for a general rate case for Class A water utilities are placed on a three year cycle as required by Pub. Util. Code § 455.2.

5. Because Class A water utilities are now subject to a three-year rate case cycle, the assumptions used in setting the rates will be much more current.

6. We have more confidence in our forecasts and assumptions under a three-year rate case plan, where the Commission scrutinizes the forecasts and assumptions used in regular intervals.

7. The annual advice letter procedure mandated by D.03-06-072 for review of balancing accounts provided has proven difficult for the Class A water utilities and Water Division to implement.

8. The recorded earnings test that D.03-06-072 mandated in connection with the annual review of balancing accounts is inconsistent with the weather-normalized earnings test applied in general rate cases and for escalation year rate adjustments, pursuant to the revised Rate Case Plan for Class A water utilities.

9. The Commission traditionally has authorized Class A water utilities to implement rate adjustments by advice letter to amortize balancing account balances only if under-or over-collections exceed two percent (2%) of annual revenues.

### **Conclusions of Law**

1. The annual advice letter filing and application of the earnings test adopted in D.03-06-072 should be eliminated.

2. Class A water utilities should report on the status of their balancing accounts in their general rate cases and should propose adjustments to their rates in that context to amortize under- or over-collections in those accounts subject to reasonableness review; they also should be permitted to propose such rate adjustments by advice letter at any time that the under- or over collection in any such account exceeds two percent (2%) of annual revenues for the utility or a ratemaking district of the utility.

3. Because utility advice letters complying with D.03-06-072 are due on or before March 31, 2006, this order should be effective immediately.

## **O R D E R**

### **IT IS ORDERED** that:

1. The California Water Association's April 4, 2005 petition for modification of Decision (D.) 03-06-072 is granted as set forth below.

2. The annual advice letter filing and application of the earnings test adopted in D.03-06-072 are eliminated.

3. Class A water utilities shall report on the status of their balancing accounts in their general rate cases and shall propose adjustments to their rates in that context to amortize under- or over-collections in those accounts subject to reasonableness review. They also may propose such rate adjustments by advice letter at any time that the under- or over-collection in any such account exceeds two percent (2%) of annual revenues for the utility or a ratemaking district of the utility.

4. Rulemaking 01-12-009 is closed.

This order is effective today.

Dated April 13, 2006, at San Francisco, California.

MICHAEL R. PEEVEY  
President  
GEOFFREY F. BROWN  
DIAN M. GRUENEICH  
JOHN A. BOHN  
ROCHELLE B. CHONG  
Commissioners